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No. [redacted]

In the

Supreme Court of the United States

FRANK SCOFIELD, Former Collector of Internal Revenue,
Petitioner,

v.

DENNIS M. O'CONNOR and KATHERINE O'CONNOR, Independent Executors of the Estate of THOMAS O'CONNOR, Deceased, and DENNIS M. O'CONNOR, KATHERINE O'CONNOR, MARY O'CONNOR BRAMAN, Joined by her Husband, D. H. BRAMAN, and THOMAS O'CONNOR, JR.,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF FOR RESPONDENTS IN OPPOSITION

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BRIEF FOR RESPONDENTS IN OPPOSITION

STATEMENT

The question in this case is whether the cash sale for the sum of $9,990,350 of a limited overriding royalty is subject to capital gain treatment under Sec. 117 of the 1939 Revenue Code where, as found by the Courts below, the sale was bona fide; had a bona fide business purpose; was not a loan or mortgage; was not an assignment or anticipation of income but was a sale of a real and substantial interest in the taxpayers' properties.

On Nov. 26, 1948 the Executors of the Estate of Thomas O'Connor, deceased, transferred, by general warranty deed, duly recorded in the deed records of Refugio County, Texas, the entire royalty interest of the Estate under eight designated tracts of land to one D. E. Blackburn for the cash consideration of $9,990,350. The royalty interest sold to Blackburn had been held by decedent and subsequently by his Estate for many years. (R. 69.) The deed provided that after the royalties described therein had produced for Blackburn the prescribed quantity of oil, the properties would revert to the grantors. (R. 69-70.) Blackburn made a substantial profit on the transaction and reported and paid tax on his profit. (R. 70.)

The sale was made for the purpose of raising funds to pay Federal estate taxes, State inheritance taxes, Federal income taxes and administration expenses of the Estate. (R. 47.)

This was the first and only sale of any type of mineral interests that the decendent or his Estate had ever made. (R.71.)

The oil payment "paid out" after three years of production and while the royalties were owned by Blackburn. The oil payment would have taken an appreciably longer period to pay out had it not been for the fact that there was an increase in the production in the field because of the drilling of additional wells by the operating lessees and had it not been for the further fact that there had been a substantial increase in the price of oil shortly prior to the

sale of the oil payment, which higher price was maintained during the period of the pay-out. (R. 71.)

If the sale is entitled to capital gain treatment, the tax on the sale is a little over $2,000,000. If, however, the proceeds are taxable as ordinary income, the tax, after allowance for depletion, will amount to over $5,600,000.

Based on a stipulation of facts and the uncontradicted testimony of two witnesses, the District Court made the following findings:

Both the sellers and the buyer, Blackburn, intended the transaction in question to be a sale and purchase of the royalty interest in question. They did not intend to enter into a loan or mortgage transaction. (R. 70.)

The transaction with Blackburn was a bona fide sale. (R.72.)

The purpose of the sale was a bona fide business purpose. (R. 70.)

The transaction was not intended to be and was not, as a matter of fact or a matter of law, an assignment of income, but was the sale of a property interest to Blackburn, which property interest produced income in the hands of Blackburn. (R. 72.)

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[1]The basis of the property sold is stipulated to be approximately $2,000,000. The selling price was approximately $10,000,000. Thus, the gain was about $8,000,000; and the capital gain tax, at 25%, was about $2,000,000. Since the sale was made to raise funds to pay very heavy estate taxes, the taxpayers feel that the Government should be content with the $2,000,000 capital gain tax and that the higher tax at normal rates should not be exacted unless plainly required by the Statute.

This property interest was substantial and real, representing a substantial part of the grantors' royalty interest. (R.72.)

The property so sold was a long-lived, and not a short-lived, oil payment. (R. 72.)

The property interest so sold to Blackburn was a capital asset as defined in Sec. 117 of the Internal Revenue Code of 1939, and this capital asset had been held by taxpayers for more than six months. (R. 72.)

The Circuit Court of Appeals, after reviewing the evidence, held that "on record made, the District Judge was right and his judgment should be affirmed."

ARGUMENT

The petition should be denied because the decision below was right; there is no conflict; and no important question affecting the revenues is presented.

Prior to 1946, the Treasury Department consistently recognized that the sale of an oil payment was the sale of capital asset under Sec. 117 of the 1939 Code. In 1946, observing that short-lived oil payments "ordinarily pay out and expire within one or two years," it was ruled that such "short-lived" oil payments, as distinguished from one "extending over a substantial portion of the depletable economic interest from which such rights are carved," should be treated as an anticipation of income and taxed

at ordinary rates. *G. C. M. 24849 (1946-1 C. B. Page 66.)*[2]

In 1950, the Treasury Department changed its position, holding that no distinction should be made between a short-lived and a long-lived oil payment and that all sales of oil payments carved out of a larger interest, irrespective of life, should be taxed at ordinary rates. *I. T. 4003, 1950-1 C. B., Page 10.*

In the *Caldwell* case, the Fifth Circuit refused to follow this later I. T., holding that sales of oil payments carved out of royalty interests and having lives of from nine to 13 years were sales of capital assets under Sec. 117. The Government did not seek certiorari in that case.

Later, the Fifth Circuit decided the *Hawn* case.[4] There, the taxpayer assigned an oil payment out of a larger one to a contractor to help finance the construction of a home. The oil payment so assigned had a life of 19 months and in the contract with the contractor, the taxpayer guaranteed the rate of interest on loans which the contractor expected to make from local banks to finance the construction and the contractor agreed to return to taxpayer part of the oil payment proceeds in event the interest on such bank loans was less than anticipated. Under the facts and considering the insubstantial nature of the oil payment, the Court held that no sale of a capital asset was made and that the tax-

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[2]The sale in question was made while this ruling was in effect and the District Court found that the oil payment in question was a long-lived one and involved a substantial part of the taxpayer's royalty.

[3]*Caldwell v. Campbell, 218 F. 2d 567 (C. C. A.-5, 1955).*

[4]*Commissioner v. Hawn, 231 F. 2d 340 (1956).*

payer would not be taxed on the proceeds from the so called "sale" but should remain taxable in the future on the sale of production attributable to the assigned oil payment.

In the cases now before the Court, the District and the Tax Court followed the *Caldwell* case and held that the taxpayers had sold capital assets. On appeal to the Fifth Circuit, the Government admitted that the *Caldwell* case was right and therefore that the extreme position taken in its 1950 ruling was wrong. The Government also agreed that where the sale, as here, was out of a royalty interest, the taxpayers had not sold income but had sold a part of their investment property. However, it contended that the Court should draw an arbitrary line between a substantial and an insubstantial oil payment, urging that the line should be drawn at a nine-year pay-out. The Fifth Circuit, refusing to draw such an arbitrary line, held that if such a line were to be drawn, it should be drawn by Congress, and not by the courts. The Court reaffirmed its earlier decision that as a general rule the sale of an oil payment, if a bona fide sale, is the sale of a capital asset entitling the taxpayer to capital gain treatment under Sec. 117. However, the Court recognized that not every sale of an oil payment would support capital gain treatment. It recognized that "The Court in each case takes all of the facts into consideration for the purpose of determining, whether as a matter of law, a transaction was or was not a sale of capital assets, so as to entitle it to capital gain treatment under Sec. 117." The Court recognized that in any "devious" transaction, as illustrated in the case of *Rudco Oil and Gas Company v. U. S., 82 Fed. Supp. 746 (Ct. Cls., 1949),*

capital gain treatment would be denied. Likewise, the Court recognized that if a sale was essentially the sale of current production, this Court's decision in *Burnet v. Harmel, 287 U.S. 103 (1932)*, would apply and the transaction, though in form a sale of property, would be taxed at ordinary rates. In addition, it recognized that if the transaction was merely "the normal source of business income," the decision of this Court in *Corn Products Co. v. Commissioner, 350 U. S. 46, 52 (1955)*, would apply and the transaction would be taxed at ordinary rates.

1. It is respectfully submitted that the decision below was right; in fact, it was the only decision that the Court could render under existing statutes.

The sale in question was a sale of a large part of taxpayers' investment property. It was a sale of "property" as that term is used in Sec. 117 and is thus within the letter of the capital gain provisions. In Texas and elsewhere, an oil payment is real property; it is in the nature of a limited overriding royalty; it descends on death as real and not personal property; it is subject to laws governing the conveyancing of real property, to ad valorem taxes on land, to recordation statutes affecting land; and in every respect is a real property interest,[5] subject to federal stamp taxes applicable to real estate sales. That such an interest is "property" is likewise recognized by the decisions of this Court.[6] Since it is "property" as that term is used in Sec.

[5] *Tennant v. Dunn, et al., 110 S. W. 2d 53 (Comm. of App.); State v. Whittenburg, 265 S. W. 2d 569; State v. Quintana Petroleum Co., 143 S. W. 2d 112 (opinion adopted by the Supreme Court, 134 S. W. 2d 1016).*

[6] *Thomas v. Perkins, 301 U. S. 655; Anderson v. Helvering, 310 U. S. 404.*

117(a), it is within the letter of Sec. 117(a) of the Code, and a sale thereof entitles the seller to capital gain treatment, since the transaction does not fall within any one of the enumerated exceptions outlined in the statute.

The sale in question was also within the spirit and purpose of Sec. 117 as well as its letter. The purpose of Sec. 117, as stated by this Court in *Burnet v. Harmel*, supra, was "to relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions." In holding that the recurring, day to day, sales of oil were not the type of property sales which Congress had in mind in adopting the capital gains provisions, the Court, in *Burnet v. Harmel*, supra, said:

> "* * * But notwithstanding this incidental transfer of ownership, it is evident that the taxation of the receipts of the lessor as income *does not ordinarily* produce the kind of hardship aimed at by the capital gains provision of the taxing act * * *. [T]heir abstraction from the soil is a *time-consuming operation* and the payments made by lessee to lessor do not *normally* become payable as the result of a *single* transaction within the taxable year, as in the case of a sale of property * * *.
>
> "* * * Such operations * * * have been said to resemble a manufacturing business * * *." (Emphasis added.)

The sale in this case was the sale of real estate, and not, as in the case of the daily production, a sale of personalty.

It was a sale of a large quantity of oil in place which was, and remained, real property. It was not the day to day recurring conversion of realty into personalty. It did not involve the time-consuming operations involved in daily sales. There was nothing in this sale that slightly resembled a manufacturing process. The sale was "a single transaction within the taxable year as in the case of the sale of property." It thus fell within the spirit and purpose of Sec. 117, which was "adopted to relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments." To tax the gain on such a sale as normal income would "produce the kind of hardship aimed at by the capital gains provisions" since it would "bunch" in a single year and tax at surtax rates graduated up to 91%, not just six months of profits, but profits of a number of years. Thus, the sale in question fell within both the spirit and purpose, as well as the letter, of Sec. 117, and, since the sale was bona fide, was not a device, did not arise in the normal course of business operations, was not a sale of current production, but was a sale of a substantial part of the taxpayer's royalty, the Court correctly found that the taxpayer was entitled to capital gain treatment.

2. There is no conflict. The Government in its petition retracts the admission made below that the *Caldwell* case was right and now contends that every oil payment sale, no matter how large or how long in duration, is to be denied capital gain treatment. No court has accepted this position. Some 25 judges have considered the Government's

proposal and, without exception, all of these judges have refused to adopt it. The proposal has been considered by the Tax Court on a number of occasions, and its decision has been reviewed by the entire Board of 16 Judges. The question has also been considered by the District Court in this case and by the Fifth Circuit on three occasions by different judges (in addition to these four cases, see *Caldwell v. Campbell*, supra; *Commissioner v. Hawn*, supra) and it has been considered by the Seventh Circuit in the *Slagter* case.[7] None of these judges accepted the Government's position.

The *Slagter* case, relied on by the Government for conflict, is clearly not in conflict. In the *Slagter* case, the transaction was with the pipe line company which had been purchasing the taxpayer's daily production. The Court held that the transaction was not a sale at all, but was a loan transaction, the taxpayer simply assigning his oil runs to secure the loan. Since there was no sale, it held that no tax at all was due on the cash payment received by the taxpayer in the year of the transaction. It held that the taxpayer should remain taxable on the monies received by the transferee in repayment of the loan. Thus, the Court did *not* hold, as the Government would represent, that the cash received in the transaction should be taxed at ordinary rates. It held that this receipt was not taxable at all. It held that other monies received in later years in repayment of the loan was to be taxed in such later years to the assignor. Very clearly, the Court, in holding that there

[7] *Slagter v. Commissioner*, 238 F. 2d 901 (1956).

was no sale, did not reach the question presented here, of whether the cash received on a true sale is to be taxed at ordinary or capital gain rates. The Court below distinguished the *Slagter* case on these differences in fact and result. The Government in its petition disagrees with the holding in the *Slagter* as well as in these cases. Moreover, the Government, though losing the *Slagter* case, did not see fit to ask for certiorari in that case, although it had ample time to do so following the decision in these cases. Apparently the Solicitor General, in deciding not to apply for a writ in *Slagter*, did not then feel there was a conflict.

The "assignment of income" cases relied on by the Government (*Helvering v. Horst*, 311 U. S. 112; *Helvering v. Clifford*, 309 U. S. 331; *Harrison v. Schaffner*, 312 U. S. 579; *Helvering v. Eubank*, 311 U. S. 122) are likewise inapposite. Those cases all dealt with the economic questions of what is income under Sec. 22(a) and who was to be taxed on such income. They all dealt with gifts of income from one member of a family to another member where the donor retained the corpus that produced the income in question. None of the cases involved a *sale* to a stranger, and none of them involved the question of the applicability of Sec. 117 to a sale. Those cases dealt simply with the question of *who* among the family members was to be taxed on income where the donor retained the income-producing property. None of them dealt with the utterly different question of *how*, and *at what rates*, a true sale of a property interest should be taxed. Moreover, those cases dealt with income in the nature of interest, dividends and rents

which were "derived from" capital; income which was separated from the producing corpus and given away; the corpus remaining intact, capable of producing additional income in future years. The sale of the oil payment in this case was not a sale of income separated from or "derived from" a non-depleting corpus. It was not the sale of the fruits from the tree; but rather the sale of a part of the tree itself; it was the sale of a part of the oil reserves in place. That which was sold was itself a separate corpus; the part retained, represented by the reversionary interest, was not a corpus producing that which was sold. The retained interest and the interest that was sold were separate and different parts of the taxpayer's investment property.

3. No question of great importance affecting the revenues is presented. The Government, in its petition, complaining of what it terms "temporary" transfers, retracts the admission made below that the *Caldwell* case was rightly decided and now takes the position that every sale of an oil payment, no matter how long its life or how large it be, should be treated as an assignment of income and taxed at ordinary rates. It says that unless this extreme position is adopted, that there will be a "widespread usage" in the oil industry of oil payments "as a device to turn ordinary income into capital gain." It states, on the matter of importance, that at the present time, "* * * this issue is involved in 43 docketed and undocketed cases which, of themselves, represent an estimated loss to the revenue of many millions of dollars if the transferors are held to have

realized capital gain rather than ordinary income." It is respectfully submitted that the Government over-states the importance of the matter.

The extreme position now taken by the Government is untenable. Its position is that if a taxpayer, owning only an oil payment having an expected life of two years, sells such oil payment, he has sold a capital asset and is entitled to capital gain, but if he sells an oil payment out of a larger interest he has ordinary income even though the oil payment so sold has a life of 13 or even 20 years. If he sells an entire oil payment representing 1,000 barrels of oil he has capital gain; but if he sells one involving a million barrels in place he has ordinary income if he retains a reversionary interest of so much as a single barrel. *I. T. 4003*, supra. If he sells an oil payment with a possibility of reverter after the oil payment pays out and the oil payment does not in fact pay out (because of a mistake in estimating reserves, reduced gas pressure, salt water encroachment, price decline, or some other cause), he has ordinary income, but if he sells exactly the same oil without a possibility of reverter, he has capital gain. As shown above, this view is unsound and is contrary to the letter and purpose of Sec. 117. No court has accepted such an extreme view. Prior to 1950, the Treasury rule was to the contrary; its first published ruling was to the contrary. *G. C. M. 24849*, supra. The admission below that the *Caldwell* case was right and the failure to apply for certiorari in that case indicate the Government's uncertainty as to the correctness

of this extreme position. If such a rule is deemed desirable Congress and not the courts should be asked to write another exception into the capital gain provisions of the law.

Nor is this extreme position necessary to the protection of the revenues. The Court below recognized that not every sale of an oil payment would entitle the transferor to capital gain treatment. As the Court below observed, the lower courts will examine the facts in each particular case to determine whether Sec. 117 applies. If the transaction is not a true sale, but in essence, a loan transaction, or is otherwise lacking in bona fides, the courts may, as in the *Haire* case, ignore the transaction and tax the transferor on the income when and as received by the transferee. Moreover, the Court below recognized that if the transaction is a mere "device to turn ordinary income into capital gain" the Courts will be quick to deny capital gain treatment. And if the transaction is essentially a sale of current production, this Court's decision in *Harmel* will be applied. Likewise, if the sale arises in the normal course of business operations, this Court's decision in the *Corn Products* case will be applied and capital gain treatment denied.

It is submitted that the pending 43 cases can be handled administratively or by lower courts within the framework of these settled principles and in accordance with the facts of each particular case. If it be said that these rules will result in some taxpayers receiving capital gain treatment and that the seller of an oil payment having a three, five, or ten year life should not have this treatment, the answer

is that Congress intended to "relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investment" (*Harmel v. Commissioner*, supra). If a change in this policy be sought, recourse should be to the Congress and not the courts.

Thus, to give this case even a tinge of importance, the Government has been forced to repudiate the position it took below that *Caldwell* and *Hawn* were correctly decided and to take the new position that *all* oil payment sales result in ordinary income. To do so is to urge this Court to legislate in much the same way it would have to legislate, were the Government to ask the Court to decide, for example, that gain from *all* sales of real estate were ordinary income since *some* persons had been accorded capital gain treatment on land sales and, as a result, many docketed and undocketed cases involving many millions of dollars were pending.

The cases are essentially fact cases,—run of the mill tax cases which were decided under established principles. If numbers of situations or dollar amounts were the criterion for granting certiorari, then this Court would hear nothing but real estate dealer cases (and decide whether the gain on sale was a capital gain or ordinary income) and family partnership cases (and review the findings of fact after a lower court has made its determination).

Here, as shown in the Statement, the lower Court has made the essential fact findings establishing this Estate's right to capital gain treatment.

CONCLUSION

Under well established principles governing the granting of certiorari, this Court will not review decisions of the lower courts, which are clearly not in conflict, which clearly apply correct principles of law, and which present no element of confusion on the part of the lower courts.

Under well established rules governinng the granting of certiorari, it is not enough for the Government simply to allege that the decided case involves loss of revenue to the Government. In any case where capital gains treatment is allowed, loss of revenue occurs. The capital gains provisions were enacted by Congress to give relief from ordinary rates in many situations deemed by Congress to merit such relief.

Nor is it enough to establish the right of review, for the Government to allege that the situation requires clarification by this Court because of pending cases. The confusion in this field is with the Government and not the courts. As pointed out above, the Government has vacillated in its position, beginning prior to 1946 when sales such as here involved were not questioned by the Government. This confusion on the part of the Government continued through the preservation of the Government's position in these cases in the lower courts where it admitted that the *Caldwell* case was correctly decided; and now the confusion continues in its petition for certiorari wherein it argues that no oil payment sale is entitled to capital gains treatment. Admittedly the Government's position throughout the history of the cases involving this question has been marked

by lack of clarity and by confusion. But this confusion has not affected the decisions of the lower courts which have consistently applied the correct principles in this area.

Thus, we submit that the Government position in its petition comes down to this: We do not like the results reached in these cases; a contrary result would mean a gain in revenue to the Government; a complete reversal of the decisions in these cases will relieve the Government of its responsibility to decide cases in this field on the basis of the particular facts in each case.

We, of course, can understand why the Government would be pleased with a reversal of these decisions, but we submit that the granting of certiorari in this case would not subserve any useful purpose and that this case is not of such importance as to warrant review by this Court. We therefore respectfully submit that the Petition for certiorari should be denied.

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